RESEARCH HIGHLIGHTS

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INSURANCE IN RESIDENTIAL CONSTRUCTION: AN ENVIRONMENTAL SCAN

Introduction

In June 2003, Canada Mortgage and Housing Corporation (CMHC), the national housing agency for the Government of Canada, provided Deloitte & Touche LLP (Deloitte & Touche) with terms of reference and a framework for conducting a study of insurance issues relative to residential construction.

Over the last three years, home builders have identified construction insurance as a critical problem area with reports of higher premiums and deductibles, reduced levels of coverage, new warranties and conditions attached to the policies as well as refusals of coverage. These recent developments are a cause of concern in the housing industry with respect to the cost and availability of insurance. The cost of insurance ultimately affects housing affordability and the profitability of the home builders' business.

The study was designed to satisfy the following key objectives:

- develop an understanding of the issues surrounding builders' risk insurance; and
- develop an understanding of the issues surrounding post-construction liability insurance.

Methodology

Primary research involved conducting interviews of new home builders, renovators, subcontractors and developers ("builders") as well as insurance companies ("insurers") and brokers, financial institutions and a variety of associations and interested organizations, across Canada. The final population list (181 companies and organizations) included participants from across Canada and encompassed organizations and companies of all sizes, product offerings and geographic areas of operation. Deloitte & Touche developed and standardized five interview guides for the Primary Research stream – one for each of the major groups of key stakeholders within the insurance environment of the Canadian residential construction industry.

Within the defined population, 100 per cent of organizations were contacted and asked to complete a survey and interview. The Primary Research stream of the Data Collection phase responses were, then, based solely on individual interest to participate. Each of the companies included within the builder population received a letter from the Canadian Home Builders' Association (CHBA) explaining the nature and purpose of the project with an invitation to participate in the study. In mid-June 2003, all key stakeholders identified in the defined population (including builder contributors) received a letter from Deloitte & Touche providing details about the project and the interview process. An advance copy of the appropriate interview guide also accompanied each letter to assist interested companies and organization in preparing for the interview.

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Following receipt of the Deloitte & Touche letter, each member of the defined population received at least one telephone call from a member of the project team, inviting him or her to participate in the primary research process. Approximately 425 follow-up telephone calls were placed. On average, each member of the defined population received 2.3 follow-up phone calls. If requested by the participant, follow-up was also conducted by e-mail or facsimile. The total interview period was 60 days (June 27 – August 26, 2003) during which interviews were scheduled at one-hour intervals with total interview time lasting an average of 60 minutes.

Response to the interview process was positive across all major key stakeholder groups with response rates varying from 20-100%. Based on an overall response rate of 28.17%, interview participants' answers should normally be considered representative of key stakeholders as a whole (see Exhibit 1). In conjunction with secondary research findings gathered during the review process, interview results can be considered a valid indicator of the current insurance environment in the residential construction industry.

Deloitte & Touche also conducted a thorough review of secondary data in four areas:

- industry scan, both construction and insurance industries;
- literature review;
- policy review; and
- regulation review.

A wide cross section of information was collected from various sources including:

- Deloitte & Touche proprietary databases;
- previously published research results from organizations such as CHBA, CMHC, the Insurance Bureau of Canada (IBC) and the Canadian Federation of Independent Businesses;
- trade and industry publications;
- news and current event articles;
- broad Internet research;
- proprietary organization and company materials;
- regulatory overviews; and
- other external research.

The key findings are extracted from interviews or secondary research material and are not an expressed opinion of Deloitte & Touche.

Exhibit 1 – Summary of Interview Population and Sample Details

Type of participant	Description	# Participants contacted, # interviews conducted, Response rate (%)												
		BC	AB	SK	MB	ON	QC	NB	NS	PEI	NL	YK NT, NU	National	TOTAL
New home builders, sub-contractors, developers, renovators	Contacted (#)	23	17	12	8	54	16	6	19		4	1		**160**
	Interviewed (#)	3	4	1	1	20	1	1	1		0	0		**32**
	Response rate (%)	13.0 %	23.5 %	8.3 %	12.5 %	37.0 %	6.3 %	16.7 %	5.3 %		0 %	0 %		**20.0 %**
Insurers, brokers	Contacted (#)						1						11	**12**
	Interviewed (#)						1						10	**11**
	Response rate (%)						100.0 %						90.9 %	**91.7 %**
Organisations, associations	Contacted (#)						1						3	**4**
	Interviewed (#)						1						3	**4**
	Response rate (%)						100.0 %						100 %	**100.0 %**
Financial institutions, lenders	Contacted (#)												5	**5**
	Interviewed (#)												4	**4**
	Response rate (%)												80.0 %	**80.0 %**
Grand Total	Contacted (#)													**181**
	Interviewed (#)													**51**
	Response rate (%)													**28.17 %**
Comments	- Response rates presented are calculated based on: (# of participants contacted / # of interviews completed) - An overall response rate of 28.17% was achieved with participants from all provinces included in interview population													

Background

In Canada, home builders acquire protection via various forms of insurance including, among others:

- builders' risk insurance, which indemnifies for loss of or damage to a building under construction (this insurance is normally written for a specified amount on the building and applies only in the course of construction with coverage customarily includes fire, extended coverage, vandalism and mischief);
- wrap-up general liability insurance, a package plan of a broad type, usually found in large residential construction projects, which is coordinated in such a way as to be applicable to all liability risks (for example, one wrap-up policy could cover all contractors working on a specific job); and
- contractors' comprehensive general liability insurance, which provides coverage for the insured, acting within their duties as such, for claims resulting in bodily injury or property damage and due to the insured's negligence.

Together, these types of coverage, whether purchased on a project-by-project or continuous basis, not only provide builders with protection for loss and liability throughout and following construction projects, but also act as a means of securing the interests of financial stakeholders associated with the project(s). Warranties may be attached to the policies, which are performance requirement of the insured as a condition of coverage and form of insurance provided to protect against latent defects in products or construction.

Key Findings on Insurance Product from Primary Research: Builder and Builder Association Responses

Insurance premiums increasing at higher rate than construction costs:

- 81.3% of builders interviewed said that, currently, increases in insurance costs are outpacing increases in construction costs.

Decrease in availability of insurance for residential construction market (carriers exiting market and reducing coverage limits):

- 84.4% of builder interview participants indicated that insurance carriers had exited the market over the last three years;
- 12.4% of builders reported that they have been denied insurance in the last 12-36 months (in all cases, builders referred to capacity limitation of the carrier; 9.4% of builders also indicated that they have been denied insurance because of the exit of carriers from the market, line of business or geography); and
- three-quarters of the builders reporting denial of insurance have found it necessary to accept lower coverage levels.

Builders indicated that the number of required warranties have increased the cost of construction:

- 50% of builders reported a general increase in the number of warranties for construction projects and 37.5% indicated that this trend towards more warranties/conditions has also increased construction cost over the last 12-36 months; and
- 9.4% of builders indicated that this increase represented 1-2% of construction cost, 3.1% indicated a 3-5% increase in cost of construction, and an equal percentage (3.1%) reporting a 5-7% increase in cost of construction precipitated by more warranties for construction projects.

In general, builders tend not to claim losses relating to theft and vandalism; theft and vandalism losses are considered a cost of doing business:

- 68.8% of builders indicated that, over the last three years, they had insurable losses but did not claim them (of these respondents, 28.1% said these losses were less than $5,000, while another 15.6% reported that unclaimed losses ranged between $5,000 and $14,999).

Builders are increasing their deductible limits:

- when outlining their recent actions to offset increasing insurance costs, 31.3% of construction companies surveyed reported that they have increased their deductible limits over the last three years.

Insurance premiums:

- when asked to identify trends in insurance for the next three years, 34.4% of builders anticipated increasing premiums while another 34.4% expected insurance premiums to stabilize.

Options for alternative forms of coverage (self-insurance, buying pools/ co-insurance) are considered but face feasibility challenges:

- when asked to identify potential trends in insurance for the next three years, 43.8% of builder respondents cited self-insurance as a developing alternative, and 62.5% also viewed co-insurance/buying pools as alternative forms of coverage for this same time period; and

- these respondents were uncertain, for a variety of reasons, about the viability of these options.

Need for communication:
- 75% of builder respondents indicated that increased communication was needed between the construction and insurance industries; and
- comments from associations indicated a need for communication about risk management and adherence to best practices.

Key Findings on Insurance Product from Primary Research: Insurer, Broker and Insurance Association Responses

Warranties:
- all insurance companies (100%) and brokers (100%) that participated in the study indicated that there has been an increase in the use of warranties in residential construction policies over the last three years; and
- when asked to forecast trends in insurance for residential construction for the next three years, 87.5% of participating insurers and 66.7% of participating brokers indicated the heightened use of warranties would not change.

Insurance premiums may stabilize:
- 87.5% of insurers interviewed along with 100% of broker participants indicated that premiums for residential construction may stabilize over the next three years; and
- 100% of insurance associations also indicated that stabilizing premiums may emerge over the next 36-month period, when asked to forecast possible insurance trends for that time period.

Need for communication:
- all insurance respondents [insurers (100%) and brokers (100%)] indicated the need for increased communication between the construction and insurance industries;
- 75% of insurers suggested that increased communication of both industries' expectations and key issues was needed;
- 100% of brokers suggested that there is a need for dialogue about industry concerns; and
- comments from associations indicated the need for communication about risk management and adherence to best practices (The Insurance Brokers Association of Ontario has developed a new course for brokers on residential construction).

Key Findings on Insurance Market from Primary Research: Insurer, Broker and Insurance Association Responses

Reduction in capacity over last three years:
- all participating insurance companies (100%) and 66.7% of broker respondents indicated that, over the last three years, there has been a decrease in the number of insurers providing coverage to the residential construction industry.

Hard market for commercial insurance:
- 37.5% of insurers surveyed and all brokers (100%) participating in the study reported the presence of a hard insurance market.

Catastrophic losses a factor affecting insurance prices:
- when asked which factors have most affected the increase in premiums over the last three years, 75% of interviewed insurers and 100% of participating brokers cited catastrophic losses (such as Liberty Walk in Calgary) as having one of the most substantial impacts.

New insurance capacity is entering the market:
- currently, new capacity is entering the market through programs such as the Encon Wood Frame Builder Risk Insurance Program; and
- when asked to forecast insurance trends relating to residential construction, 75% of insurers and 100% of brokers interviewed reported possible increases in capacity over the next three years.

More underwriters may enter the market now that costs have increased:
- in consideration of a perception of increased profits, 62.5% of insurance companies participating in the study and 100% of brokers interviewed forecasted a possible increase in the number of insurers underwriting residential construction over the next three years.

Some underwriters may increase the amount they are willing to underwrite:
- when asked about forecasted levels of underwriting, 37.5% of surveyed insurers projected an increase in underwriting levels for residential construction over the next three years.

The IBC is working on new standard policy wording and warranties:

- when asked to forecast trends in insurance for residential construction, 37.5% of insurers anticipated the possible emergence of a trend towards standardized wordings over the next three years.

Key Findings on Insurance Industry Structure from Primary Research: Insurer, Broker and Insurance Association Responses

Rates for all commercial policies have increased over the last three years and underwriting has been much stricter:

- 75% of insurers and 100% of brokers cited increases in rates over the last three years; and
- similarly, 75% of insurance companies interviewed and 100% of participating brokers indicated increased strictness in underwriting in this same time period.

Key Findings on Lending Market from Primary Research: Lender Responses

No change expected in levels of residential construction lending over next three years:

- 75% of participant lenders do not expect any change in residential construction lending levels for the next three years.

Increasing review by lending institutions in relation to insurance requirements for borrowers:

- half of lender respondents (50%) stated they were increasing their review with respect to insurance requirements for residential construction clients.

Increased insurance requirements for builders to acquire financing:

- of those lenders surveyed, 75% reported increasing requirements by the lending institution for residential construction clients to comply with insurance policy warranties in order to acquire financing.

Key Findings on Insurance Product from Secondary Research

In the last three years, trends in insurance have emerged including increasing premiums for construction insurance policies, lowering of coverage maximums, and increasing refusals of coverage – extent of these trends varies at the individual project and company level.

Insurers are imposing much higher premiums and deductibles as well as incorporating more restrictive coverage language in policies to mitigate the trend towards risk-transfer losses (subcontractors to contractor or vice versa) and construction defect claims.

Builders have experienced difficulties in securing coverage (including refusal of coverage) and a small percent has not been able to secure any coverage.

Increasing presence of limiting language (exclusions and warranties) in new and renewed policies.

Policy wording remains non-standardized within the residential construction market.

Recent case-law arising from claims has extended liability to builders.

Frequency of insurance claims remains stable, but severity of claims and cost are increasing.

Builders have begun voluntarily increasing deductible limits.

Builders are attempting to offset and mitigate premium increases through a variety of methods including early renewals, changing insurers, increasing deductibles, establishing formal risk management and risk transfer programs, more accurate cost forecasting, self-insurance, reducing coverage, educating insurers about the company's business, negotiating policy terms and avoiding unnecessary claims.

Construction companies are moving towards larger levels of self-insurance in the USA.

Key Findings on Insurance Market from Secondary Research

Three consecutive years of increasing rates and decreasing capacity (hard market).

Canadian post-September 11 experience pertaining to insurance is not unlike that of the international insurance market.

Recent decreases in the supply of insurance to residential construction markets have been coupled with an increase in demand for insurance.

Fewer insurers are willing to underwrite residential construction and those that will require much more information on an ongoing basis.

Liability premiums are increasing across all businesses, among the hardest hit are contractors, especially multi-family builders.

Concern about growing levels of construction defect litigation has led to multi-family projects being labelled as high-risk because of the opportunity for flaw repetition.

Uncertainty about the magnitude and implications of mold-related exposures is causing increasing concern for and receiving increasing attention from the insurance industry in the USA.

Conclusion

According to the research conducted, the insurance market for all types of commercial coverage has hardened over the last three years. A "hard" market designates an environment characterized by rising prices and reductions in capacity to underwrite insurance. The market has reacted to the events of September 11, reductions in reinsurance capacity, poor underwriting results and a difficult investment climate.

The insurance industry's appetite for insuring residential construction projects has been particularly weak in response to widely publicized catastrophic fires at construction sites at several different locations across Canada and the emergence of new risks such as mold and terrorism. The insurance market for residential construction is contracting, with lower risk tolerance and fewer companies participating in the market.

Project Manager: Eric Tsang

Executive Summary Report: *Insurance in Residential Construction: An Environmental Scan, Executive Summary Findings Report*

Research Report: *Insurance in Residential Construction: An Environmental Scan, Detailed Findings Report*

Research Consultant: Deloitte & Touche LLP

Housing Research at CMHC

Under Part IX of the National Housing Act, the Government of Canada provides funds to CMHC to conduct research into the social, economic and technical aspects of housing and related fields, and to undertake the publishing and distribution of the results of this research.

This fact sheet is one of a series intended to inform you of the nature and scope of CMHC's research.

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